APPENDIX 4

Worcester CITY COUNCIL

Treasury Management Strategy Statement 2019/20

INDEX

Introduction

Treasury management is the management of the Authority's cash flows, borrowing and investments, and the associated risks. The Authority borrows and invests substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to the Authority's prudent financial management.

Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2017 Edition* (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year. This report fulfils the Authority's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

Investments held for service purposes (to support local public services) or for commercial profit (to earn investment income, where this is the main purpose) are considered in a different report, the Investment Strategy. This includes potential investments related to the Development Fund.

Figures and tables throughout this document are based on the current capital programme and the resulting projections for borrowing and investment. As such the amounts are subject to change if additional investment decisions crystallise.

Background

The Council is required to operate a balanced budget, which broadly means that the cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's risk appetite, providing adequate liquidity initially before considering investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning, to ensure that the Council can meet its capital spending obligations. This management of longer term cash flow surpluses may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion, any debt previously drawn may be restructured to meet Council risk or cost objectives.

Treasury management operations are defined by CIPFA as follows:-

> *"the management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."*

The council has adopted the 2017 CIPFA Code of Practice on Treasury Management in the Public Services and the 2017 Prudential Code for Capital Finance in Local Authorities. Since the last edition of the Treasury Management Code was published in 2011, the landscape for public service delivery has changed significantly following the sustained period of reduced public spending and the developing need to fund services from alternative sources. Updates reflect changes in the regulatory environment, the increasing use of a wider range of investment opportunities and include streamlined reporting requirements to promote engagement.

The Council operates in accordance with the Council's own approved Treasury Management Practices (TMPs) which are operating procedures and statements that form a subset of the Treasury Management Documents.

The code identifies three key principles which are in place in Worcester City:

i that the Council should put in place formal and comprehensive objectives, policies and practices, strategies and reporting arrangements for the effective management and control of their treasury management arrangements

ii that the Council's policies and procedures should make clear that the effective management and control of risk are prime objectives in the treasury management arrangements, and that it is clear where responsibility for these lies within the organisation. The appetite for risk should be made clear in the annual strategy document and priority should be given to security and liquidity when investing funds. CIPFA endorses an approach of more emphasis being placed on managing and avoiding risks rather than maximising returns.

iii that the Council's policies and practices should reflect the fact that whilst the pursuit of value for money in treasury management is a valid business objective, and the use of suitable performance measures are important tools, this has to be within the context of effective risk management.

The Council's proposed treasury management strategy for 2019/20 is based upon officer views on interest rates, supplemented with market forecasts provided by Arlingclose who are the Council's treasury advisors.

External Context

Economic Background

The UK's progress in negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2019/20.

UK Consumer Price Inflation (CPI) for October was up 2.4% year/year, slightly below the consensus forecast and broadly in line with the Bank of England's November Inflation Report. The most recent labour market data for October 2018 showed the unemployment rate edged up slightly to 4.1% while the employment rate of 75.7% was the joint highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily and provide some pull on general inflation. Adjusted for inflation, real wages grew by 1.0%, a level still likely to have little effect on consumer spending.

The rise in quarterly GDP growth to 0.6% in Q3 from 0.4% in the previous quarter was due to weather-related factors boosting overall household consumption and construction activity over the summer following the weather-related weakness in Q1. At 1.5%, annual GDP growth continues to remain below trend. Looking ahead, the BoE, in its November Inflation Report, expects GDP growth to average around 1.75% over the forecast horizon, providing the UK's exit from the EU is relatively smooth.

Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since. However, the Bank expects that should the economy continue to evolve in line with its November forecast, further increases in Bank Rate will be required to return inflation to the 2% target. The Monetary Policy Committee continues to reiterate that any further increases will be at a gradual pace and limited in extent.

While US growth has slowed over 2018, the economy continues to perform robustly. The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the current 2%-2.25% in September. Markets continue to expect one more rate rise in December, but expectations are fading that the further hikes previously expected in 2019 will materialise as concerns over trade wars drag on economic activity.

Credit Outlook

The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ring-fencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ring-fenced banks that now only conduct lower risk retail banking activities. Barclays Bank, HSBC Bank, Lloyds Bank Corporate Markets and NatWest Markets are the investment banks. Credit rating agencies have adjusted the ratings of some of these banks with the ring-fenced banks generally being better rated than their non-ring-fenced counterparts.

The Bank of England released its latest report on bank stress testing, illustrating that all entities included in the analysis were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.

European banks are considering their approach to Brexit, with some looking to create new UK subsidiaries to ensure they can continue trading here. The credit strength of these new banks remains unknown, although the chance of parental support is assumed to be very high if ever needed. The uncertainty caused by protracted negotiations between the UK and EU is weighing on the creditworthiness of both UK and European banks with substantial operations in both jurisdictions.

Interest Rate Forecast

Following the increase in Bank Rate to 0.75% in August 2018, the Authority's treasury management adviser Arlingclose is forecasting two more 0.25% hikes during 2019 to take official UK interest rates to 1.25%. The Bank of England's MPC has maintained expectations for slow and steady rate rises over the forecast horizon. The MPC continues to have a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. Arlingclose believes that MPC members consider both that ultra-low interest rates result in other economic problems, and that higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.

The UK economic environment remains relatively soft, despite seemingly strong labour market data. Arlingclose's view is that the economy still faces a challenging outlook as it exits the European Union and Eurozone growth softens. Whilst assumptions are that a Brexit deal is struck and some agreement reached on transition and future trading arrangements before the UK leaves the EU, the possibility of a "no deal" Brexit still hangs over economic activity. As such, the risks to the interest rate forecast are considered firmly to the downside.

Gilt yields and hence long-term borrowing rates have remained at low levels but some upward movement from current levels is expected based on Arlingclose's interest rate projections, due to the strength of the US economy and the ECB's forward guidance on higher rates. 10-year and 20-year gilt yields are forecast to remain around 1.5% and 2% respectively over the interest rate forecast horizon, however volatility arising from both economic and political events are likely to continue to offer borrowing opportunities.

A more detailed economic and interest rate forecast is at **Appendix A**.

Local Context

On 31st December 2018 the Authority held £7.3m of borrowing and £27.6m of investments. This is set out in further detail at **Appendix B**. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Balance sheet summary and forecast

Table 1	**31.03.18 Actual £m**	**31.03.19 Estimate £m**	**31.03.20 Forecast £m**	**31.03.21 Forecast £m**	**31.03.22 Forecast £m**
General Fund CFR	11.5	11.2	11.8	11.4	10.9
Less: External Borrowing	(7.4)	(7.3)	(7.3)	(7.2)	(7.1)
Internal Borrowing	4.1	3.9	4.5	4.2	3.7
Less: Usable reserves	(14.6)	(11.8)	(11.1)	(11.5)	(11.7)
Less: Working capital	(0.6)	(6.0)	(7.4)	(4.9)	(2.9)
Investments	11.1	13.9	14.0	12.2	10.9

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. The Council is currently maintaining an internally-borrowed position of approximately £4.0m. A large multi-year prepayment to the pension fund in 2017/18 dampened working capital in that year.

Excluding the impact of any potential commercial property investment, the underlying need to borrow remains relatively stable over the next three years. This is due to the majority of planned capital expenditure being funded from existing resources.

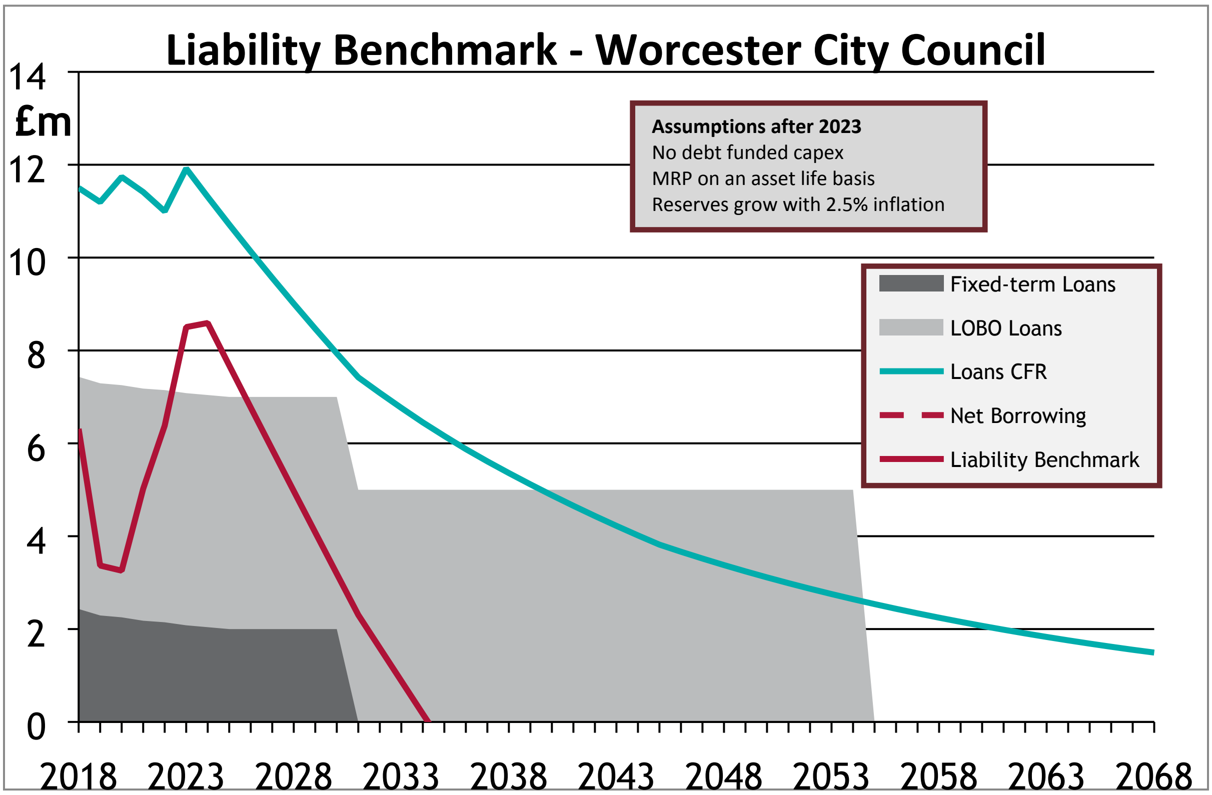
CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Authority expects to comply with this recommendation during 2019/20.

<u>Liability Benchmark</u>

To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as table 1 above, but that cash and investment balances are kept to a minimum level of £10m at each year-end to maintain sufficient liquidity but minimise credit risk.

Table 2	**31.03.18 Actual £000**	**31.03.19 Estimate £000**	**31.03.20 Forecast £000**	**31.03.21 Forecast £000**	**31.03.22 Forecast £000**
CFR	11,502	11,218	11,755	11,369	10,859
Less: Usable Reserves	(14,600)	(11,841)	(11,092)	(11,504)	(11,729)
Less: Working capital	(590)	(5,990)	(7,390)	(4,890)	(2,890)
Net Borrowing requirement before minimum Investments	(3,688)	(6,613)	(6,727)	(5,025)	(3,760)
Plus: Minimum investments	10,000	10,000	10,000	10,000	10,000
Liability Benchmark	6,312	3,387	3,273	4,975	6,240

Based on a stable CFR the amount of external borrowing is predicted to remain above the absolute minimum (as indicated by the liability benchmark) for the majority of the timeframe. Over the medium term as usable reserves are utilised the amount of cash available for investments reduces and the gap between external borrowing and the liability benchmark narrows.



Borrowing Strategy

Current Portfolio Position:

	2017/18 £000's	2016/17 £000's
P.W.L.B.	**2,334**	3,367
LOBO Loan	**5,000**	5,000
	7,334	8,367
Maturing within one year	**5,041**	6,033
Maturing in 1-2 years	**41**	41
Maturing in 2-5 years	**171**	147
Maturing in 5-10 years	**81**	146
Maturing in more than 10 years	**2,000**	2,000
	7,334	8,367

The Authority currently holds £7.3 million of loans, a decrease of £1.033 million on the previous year, which was predominately made up of a £1 million repayment of a PWLB loan relating to the Local Authority Mortgage Scheme (LAMS). The balance sheet forecast in table 1 shows that the Authority does not expect to need to borrow in 2019/20 for capital programme purposes. The Authority may, however, borrow to fund investment under the Development Fund. The operational boundary for borrowing in 2019/20 needs to be set to enable sufficient borrowing to meet the objectives of the Development Fund.

This is reviewed as part of the Capital Strategy published alongside the budget report.

Objectives: The Authority's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should the Authority's long-term plans change is a secondary objective.

Strategy: Given the significant cuts to public expenditure and in particular to local government funding, the Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

By doing so, the Authority is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Authority with this 'cost of carry' and breakeven analysis. Its output may determine whether the Authority borrows additional sums at long-term fixed rates in 2019/20 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

Alternatively, the Authority has an option to arrange forward starting loans during 2019/20, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period. In addition, the Authority may borrow short-term loans up to one year to cover unplanned cash flow shortages upon authorisation of the Head of Finance.

Prior to any decisions being made on long-term borrowings, a financial review will be undertaken and this will be reported through to Council to inform any future strategy and actions. The following points will be considered:

- the on-going revenue liabilities created and the implications for future plans and budgets
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow
- the merits and demerits of alternative forms of funding
- the most appropriate periods to fund and repayment profiles to use

Sources of borrowing: The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- any institution approved for investments
- any other bank or building society authorised to operate in the UK
- any other UK public sector body

- UK public and private sector pension funds (except the Worcestershire County Council Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues.

Other sources of debt finance: In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- leasing
- hire purchase
- Private Finance Initiative
- sale and leaseback

The Authority has previously raised some of its long-term borrowing from the PWLB but it continues to investigate other sources of finance, such as local authority loans and bank loans, that may be available at more favourable rates.

Municipal Bonds Agency: UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a joint and several guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to full Council.

LOBOs: The Authority holds a £5m LOBO (Lender's Option Borrower's Option) loan where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. This LOBO has two call dates during 2019/20, and although the Authority understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Authority will take the option to repay the LOBO loan at no cost if it has the opportunity to do so and replace with shorter-dated loans in line with the latest CFR projections, this was agreed at a Council meeting dated 5th November 2009. Total borrowing via LOBO loans will be limited to the current £5m.

Short-term and variable rate loans: These loans leave the Authority exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators later in this report.

Debt rescheduling: The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Authority may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

Prospects for borrowing rates:

The Council's treasury advisors Arlingclose have formulated a view on PWLB interest rates up until December 2021 based on a maturity basis as follows.

	5 year	**10 year**	**20 year**	**50 year**
Dec 2018	1.95%	2.40%	2.70%	2.60%
March 2019	2.00%	2.45%	2.75%	2.65%
June 2019	2.05%	2.45%	2.75%	2.65%
Sept 2019	2.15%	2.50%	2.80%	2.70%
Dec 2019	2.20%	2.55%	2.80%	2.70%
March 2020	2.20%	2.55%	2.80%	2.70%
June 2020	2.15%	2.55%	2.80%	2.70%
Sept 2020	2.15%	2.50%	2.80%	2.70%
Dec 2020	2.10%	2.50%	2.80%	2.70%
March 2021	2.10%	2.50%	2.80%	2.70%
June 2021	2.10%	2.50%	2.80%	2.70%
Sept 2021	2.10%	2.50%	2.80%	2.70%
Dec 2021	2.10%	2.50%	2.80%	2.70%

Investment Strategy

As at 31st March 2018 the Authority held £10.8m of invested funds. This represented income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority's investment balance has ranged between £9.3m and £24.6m and similar levels are expected to be maintained in the forthcoming year. As a billing authority, cash balances tend to be higher mid-financial year with balances reducing in later months as amounts are paid to precepting authorities.

Objectives: The CIPFA Code requires the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Authority will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

Negative interest rates: If the UK enters into a recession in 2019/20, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Strategy: Given the increasing risk and very low returns from short-term unsecured bank investments, the Authority aims to further diversify into more secure and/or higher yielding asset classes during 2019/20 (e.g. multi asset income funds). This is especially the case for money that is available for longer-term investment. The majority of the Authority's surplus cash remains invested in short-term unsecured bank deposits, certificates of deposit and money market funds. This diversification will represent a continuation of the new strategy adopted in 2018/19 (the Authority invested in a pooled property fund) .

Business models: Under the new IFRS 9 standard, the accounting for certain investments depends on the Authority's "business model" for managing them. The Authority aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

Approved counterparties: The Authority may invest its surplus funds with any of the counterparty types in the table below, subject to the time limits shown.

Approved investment credit ratings and time limits

Credit Rating	**Banks unsecured**	**Banks secured**	**Government**	**Corporates**	**Registered Providers**
UK Govt	N/A	N/A	50 years	N/A	N/A
AAA	5 years	25 years	50 years	20 years	20 years
AA+	5 years	10 years	25 years	10 years	10 years
AA	4 years	5 years	15 years	5 years	10 years
AA-	3 years	4 years	10 years	4 years	10 years
A+	2 years	3 years	5 years	3 years	5 years
A	13 months	2 years	5 years	2 years	5 years
A-	6 months	13 months	5 years	13 months	5 years
Pooled funds and REITs			25 years		

This table must be read in conjunction with the notes below.

Credit rating: Investment limits are set by reference to the lowest published long-term credit rating from a selection of external rating agencies. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

Banks unsecured: Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See below for arrangements relating to operational bank accounts.

Examples of unsecured banks instruments:

Fixed Term Deposits: are financial instruments provided by banks which provide investors with a higher rate of interest than regular savings accounts and cannot be broken until the agreed maturity date.

Certificates of Deposits: are a negotiable form of fixed term deposit. The difference is that you are not obliged to hold the investment to maturity, it is possible to realise the cash by selling it in the secondary market. This gives an added benefit of liquidity over a fixed term deposit.

Banks secured: Covered bonds, covered floating rate notes, repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

Example of a secured bank instrument:

Covered Floating Rate Notes: are money market instruments with floating/variable rates of interest which re-fix over a reference rate, for example LIBOR. The rate of return usually re-fixes every 3 months at a set margin over LIBOR. They are primarily used as a way of manging interest rate risk. They have strong security as they are often backed by a pool of mortgages.

Government: Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

Example of a government instrument:

Treasury Bills: are short-dated forms of UK government debt issued by the Debt Management Office (DMO) via a weekly tender. Usually for 1, 3 and 6 month periods.

Corporates: Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made either following an external credit assessment.

Registered providers: Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords, formerly known as housing associations. These bodies are tightly regulated by the Regulator of Social Housing. As providers of public services, they retain the likelihood of receiving government support if needed.

Pooled funds: Shares or units in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives will be monitored regularly.

Examples of pooled funds:

<u>Money Market Funds</u>: are a type of open-ended mutual fund that invests in short-term debt securities characterised by their minimal credit risk. They are highly liquid as cash can be drawn back at any notice.

<u>Ultra Short Dated Bond Funds:</u> are a type of bond fund that invests only in fixed-income instruments i.e. asset and mortgage backed corporate, treasury and government agency securities with short-term maturities usually around one year.

<u>Property Funds:</u> these are pooled investment vehicles whose assets mainly comprise property holdings. These can be focused on a specific sector or include a multitude of types, for examples retail, offices, industrial units etc.

Real estate investment trusts (REITs): Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.

Operational bank accounts: The Authority may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments, but are still subject to the risk of a bank bail-in, and balances will therefore be kept to a minimum subject to cash flow requirements. The Bank of England has

stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Authority maintaining operational continuity.
Risk assessment and credit ratings: Credit ratings are obtained and monitored by the Authority's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other information on the security of investments: The Authority understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from the Authority's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Authority will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Authority's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

Investment limits: The Authority's revenue reserves available to cover investment losses are forecast to be £10 million on 31st March 2019. In order that no more than 20% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government or pooled funds) will be £2 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

	Cash Limit
Any single organisation, except UK Central & Local Government, Pooled Funds	£2m each
UK Central Government	Unlimited
UK Local Government	£3m per authority
Any group of organisations under the same ownership	£3m per group
Any group of pooled funds under the same management	£3m per manager
Negotiable instruments held in a broker's nominee account	£6m per broker
Foreign countries (in accordance with minimum ratings)	£3m per country
Registered Providers and Registered Social Landlords	£3m in total
Unsecured investments with building societies	Not permitted
Loans to unrated corporates	Not permitted
Money market funds	£12m in total
Real estate investment trusts	£3m in total

Liquidity management: The Authority uses purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Authority being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Authority's medium-term financial plan and cash flow forecast.

Bank Rate Forecast:

Dec 2018	0.75%
March 2019	1.00%
June 2019	1.00%
Sept 2019	1.25%
Dec 2019	1.25%
March 2020	1.25%
June 2020	1.25%
Sept 2020	1.25%

Dec 2020	1.25%
March 2021	1.25%
June 2021	1.25%
Sept 2021	1.25%
Dec 2021	1.25%

This is subject to many economic and political factors including the outcome of Brexit, future inflation levels, GDP growth and movements in the US Fed. However current expectations are that there will be a slow, gentle rise in interest rates over the forecast horizon.

Investment Return Expectations: Suggested budgeted investment earnings for each year are as follows:

2018/19	0.60%
2019/20	0.85%
2020/21	1.10%
2021/22	1.30%
2022/23	1.50%
2023/24	1.60%

Treasury Management Indicators

The Authority measures and manages its exposures to treasury management risks using the following indicators.

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average [credit rating / credit score] of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Credit risk indicator	**Target**
Portfolio average credit rating	AA-

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

Liquidity risk indicator	**Target**
Total cash available within 3 months	£5m

Interest rate exposures: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	Target £000
Upper limit on one-year revenue impact of a 1% rise in interest rates	101
Upper limit on one-year revenue impact of a 1% fall in interest rates	(101)

Maturity structure of borrowing: This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal sums invested for periods longer than a year: The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

Liquidity risk indicator	2019/20	2020/21	2021/22
Limit on principal invested beyond year end	£3m	£2m	£1m

Related matters

The CIPFA Code requires the Authority to include the following in its treasury management strategy.

Financial Derivatives: Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act*

2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).
The Authority will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Authority is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

Markets in Financial Instruments Directive: The Authority has retained retail client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Authority's treasury management activities, the Head of Finance believes this to be the most appropriate status.

Policy, Legal, Financial, Equality and Risk Management Implications

Policy: The effective management of the investment portfolio is critical to the overall success of the Council's service objectives. It is therefore essential that the Council is positioned to enable it to optimise investment returns whilst showing due diligence to the effective management of risk in all treasury management dealings.

Legal: As Treasury Management forms part of the Budget Framework, Full Council is required to approve any changes to the TM Policy Statement, TM Strategy and corresponding Prudential Indicators, TM Practices, Investment Strategy, MRP Statement, Capital Programme and Capital Strategy.

Financial: The income generated by the Council's investments and the interest paid on loans and MRP are all key elements of the Council's financial resources. The budget for investment income in 2019/20 is £245k. This is made up of £120k in relation to Property Fund dividends (£3m @ 4%) and £125k for all other investments. The £125k is based on an average investment portfolio of £14.7m and an average rate of 0.85% being achieved. The budget for debt interest paid in 2019/20 is £335k, based on an average debt portfolio of £7.3m at an average interest rate of 4.59%. If actual levels of investments and borrowing, or actual interest rates, differ from those forecast, performance against budget will be correspondingly different. Further details can be found in the MTFP and proposed budget for 2019/20 and in the Capital Strategy and Investment Strategy reports published alongside it.

Equalities: None directly arising from this report.

Risk: The Council's strategy will ensure that the management of risk is paramount in all of the Council's TM operations.

Risk Assessment Matrix

1 Likelihood of occurrence **LOW,** Impact **NOTICEABLE**
2 Likelihood of occurrence **MEDIUM,** Impact **NOTICEABLE**
3 Likelihood of occurrence **LOW,** Impact **SIGNIFICANT**
4 Likelihood of occurrence **HIGH,** Impact **NOTICEABLE**
5 Likelihood of occurrence **MEDIUM,** Impact **SIGNIFICANT**
6 Likelihood of occurrence **LOW,** Impact **CRITICAL**
7 Likelihood of occurrence **HIGH,** Impact **SIGNIFICANT**
8 Likelihood of occurrence **MEDIUM,** Impact **CRITICAL**
9 Likelihood of occurrence **HIGH,** Impact **CRITICAL**

Risk assessment of Treasury management operations				
Risk No.	**Description**	**Risk Score**	**Management Action Plan**	**Target Score**
1	Failure of internal procedures	3	Regular review and update of Strategy and operational procedures in this report. Annual Internal Audit check.	3
2	Failure to secure revenue income from money market	1	Annual review of economic indicators and interest forecasts form part of the Medium Term Financial Forecast and annual budget setting.	1
3	Failure to secure capital from money invested	1	Prudent policy and risk averse strategy in counterparty lists and regular review against credit ratings and money market advice.	1

Other Options Considered

The CIPFA code does not prescribe any particular treasury management strategy for local authorities to adopt. The Head of Finance believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater

Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

Appendix A

Arlingclose Economic & Interest Rate Forecast December 2018

Underlying assumptions:

- Our central interest rate forecasts are predicated on there being a transitionary period following the UK's official exit from the EU.
- The MPC has a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. We believe that MPC members consider that: 1) tight labour markets will prompt inflationary pressure in the future, 2) ultra-low interest rates result in other economic problems, and 3) higher Bank Rate will be a more effective policy weapon if downside risks to growth crystallise.
- Both our projected outlook and the increase in the magnitude of political and economic risks facing the UK economy means we maintain the significant downside risks to our forecasts, despite the potential for slightly stronger growth next year as business investment rebounds should the EU Withdrawal Agreement be approved. The potential for severe economic outcomes has increased following the poor reception of the Withdrawal Agreement by MPs. We expect the Bank of England to hold at or reduce interest rates from current levels if Brexit risks materialise.
- The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in the middle quarters of 2018, but more recent data suggests the economy slowed markedly in Q4. Our view is that the UK economy still faces a challenging

outlook as the country exits the European Union and Eurozone economic growth softens.

- Cost pressures are easing but inflation is forecast to remain above the Bank's 2% target through most of the forecast period. Lower oil prices have reduced inflationary pressure, but the tight labour market and decline in the value of sterling means inflation may remain above target for longer than expected.

- Global economic growth is slowing. Despite slower growth, the European Central Bank is conditioning markets for the end of QE, the timing of the first rate hike (2019) and their path thereafter. More recent US data has placed pressure on the Federal Reserve to reduce the pace of monetary tightening – previous hikes and heightened expectations will, however, slow economic growth.

Forecast:

- The MPC has maintained expectations of a slow rise in interest rates over the forecast horizon, but recent events around Brexit have dampened interest rate expectations. Our central case is for Bank Rate to rise twice in 2019, after the UK exits the EU. The risks are weighted to the downside.

- Gilt yields have remained at low levels. We expect some upward movement from current levels based on our central case that the UK will enter a transitionary period following its EU exit in March 2019. However, our projected weak economic outlook and volatility arising from both economic and political events will continue to offer borrowing opportunities.

<u>Appendix B</u>

Existing Debt and Investment Portfolio Position

	31.12.2018 Actual Portfolio £m
External borrowing:	
Public Works Loan Board (PWLB)	2.3
LOBO loans from banks	5.0
Local authorities	0
Other loans	0
Total external borrowing	**7.3**
Other long-term liabilities:	
Private Finance Initiative	0
Finance Leases	0
Transferred Debt	0
Total other long-term liabilities	**0**

Total gross external debt	**7.3**
Treasury investments:	
Banks (unsecured)	-5.3
Covered bonds and REPO (secured)	0
Government (including local authorities)	-10.0
Corporate bonds and loans	0
Money Market Funds	-9.3
Property Funds	-3.0
Other pooled funds	0
Real estate investment trusts (REITs)	0
Total treasury investments	**-27.6**